

Using Fear to Advantage

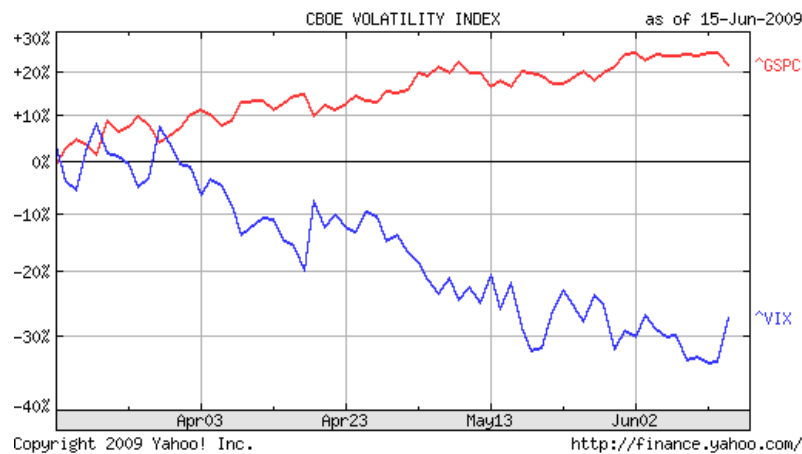
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When fear is personal, it can drive investors to act impulsively and financially harm themselves. For example, a common urge is to sell stock at market lows due to fright and apprehension.

On the other hand, when fear is impersonal, it can be used to advantage because it is less threatening. This is how. The volatility index from the Chicago Board of Trade (VIX) is an important assessment of near-term volatility market expectations expressed by S&P 500 stock index option prices. Generally, increased volatility indicates fear. When fear is up, the markets tend to go down. When fear is down, the markets tend to go up. Some use VIX to indicate turning points in the market.

For example, in the chart below from Yahoo Finance, the three month chart of the percentage change in VIX shown in blue versus the S&P (GSPC) shown in red indicates a downward trend of the fear index and an upward trend of the S&P. Only recently have these directions diverged suggesting that there might be a change in sentiment. If so, it could correlate with a switch in the direction of the market.



Though the chart gives a strong indication as to why VIX is generally accepted as an excellent indicator of wide investor emotion, using it as the only gauge of when to buy or sell stock is oversimplified. This is because CBOE has other volatility indexes to work with. These are among others, VXD, the Dow Jones volatility index, and VNX, the NASDAQ volatility index. Each gauges volatility for its particular index. In addition, some investors use other indicators as well such as technical and/or price/earnings valuation. Whatever the complexity of a market

analysis, using an impersonal fear gauge to advantage can only be a good thing. It certainly beats a personal internal monitor. As Peter Lynch said, "The key to making money in stocks is not to get scared out of them."